BEFORE THE SUBCOMMITTEE ON SURFACE TRANSPORTATION AND MERCHANT MARINE OF THE SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

HON. GORDON SMITH, PRESIDING

MAY 9, 2001

TESTIMONY OF KEVIN KAUFMAN

Chairman Smith and distinguished members of the Committee: My name is Kevin Kaufman. I am a Senior Vice President of Louis Dreyfus Corporation ("LDC"), a domestic and international marketer of grain, grain products, and other commodities that move by rail, barge, truck and ocean carriers. Since 1996, I have served as a member of the Railroad-Shipper Transportation Advisory Council ("RSTAC"), which was created by the ICC Termination Act ("ICCTA") to focus on concerns of small railroads and small shippers.

I very much appreciate the opportunity to appear and testify today and to present my views on the importance of a financially secure rail industry, capable of future growth to meet the needs of an expanding U.S. economy.

LDC is totally transportation-dependent. We treat transportation as a valuable commodity whose understanding is one of the key value-drivers for our company. Not only do we incorporate transportation into all of our major trading decisions, but the value of our physical assets are also transportation-dependent. We presently operate major export grain terminals at Portland, OR, Seattle, WA, the Texas Gulf, Port Cartier, Quebec, and throughout Western Canada, as well as a large rice milling operation in Southeastern Missouri. In addition, to enhance our shipping flexibility, our company operates a substantial fleet of our own rail cars.

As you know, the merger-related rail service breakdowns that began in 1997 induced a critical review of railroad performance from a number of interested parties, including Congress, the Surface Transportation Board ("STB"), and Wall Street. Few have been more critical than I of the failure of railroad management to properly value their acquisitions and to anticipate the real costs of operationally consolidating the merging properties.

However, having said that, I think that current dialogue must focus on the more important strategic question of whether the industry is capable of providing the transportation capacity and management required to sustain a growing economy. My purpose here today is to argue that in spite of the general search for regulatory scapegoats, the real issue is a failure to enact consistent, intermodal public policy that provides an economic environment in which the rail industry can compete.

Recession is a mask for service performance. And, therefore, it would be a mistake to view the apparent lessening of current service problems or even the attainment of some service improvements as evidence of fundamental, improved structural changes within the railroad industry. While management continues to squeeze improvements out of their organizations, I do not see any of the major changes to their economic operating environment as sufficient to sustain long-term industry financial health. Yet the U.S. economy will again begin to grow and the demand for commercial transportation of goods and services will outstrip railroad industry infrastructure carrying capacity. In fact, in my discussions with the various interested parties in the issue at hand, while their prescriptions vary widely, most agree that failure to address policy issues will result in a deterioration of the financial health of the rail industry and have a destructive impact upon the U.S. economy. In my opinion, the more important point is that, to a large extent, past railroad management behavior was at least in part a reaction to the economic signals that government policy was communicating.

The Staggers Act relieved the railroads of much of the down-side of regulatory burden that made it difficult for them to maximize the opportunities inherent in their franchises. The ability to price differentially and to dispose of under-performing infrastructure allowed them to significantly reduce their costs per unit. At the same time, double-stacking technology and the ability to increase corridor density made it possible for railroads to convert under-utilized capacity to become effective intermodal competitors. The expectation was that not only would intermodal provide the volume necessary to consume under-utilized capacity, but it would actually increase the railroad market "pie," thereby increasing earnings. Unfortunately, while intermodal did provide the additional volume allowing overall railroad cost per unit to decline (cross-subsidization), their need to price their services competitively with trucks arguably has resulted in earnings that failed to fully cover the costs of operation plus the significant required investment.

The railroad industry regards itself as hampered in attempting to achieve its goals by the remaining vestiges of regulation and by long-standing public concepts of the role of common carriers. This debate has partially manifested itself through the introduction of several pieces of legislation over the past few years. Clearly, it is economically inefficient and counter-productive if, on the one hand, an industry sometimes behaves as if it has the obligation to supply equal service for all consumers, no matter their relative economic cost, and, on the other, is required to fully pay for the investment and incremental operational cost. There is a significant cost when the politics of public policy fail to take into account the economic impact of those policies. The point is that the political environment often influences uneconomic behavior.

Therefore, I am here to try to persuade you to consider solutions that address the inequities of current public policy. I believe that it is long-term counterproductive for public policy to appropriate subsidies that essentially disincent the investment in the railroad industry. Railroads cannot price their services at levels that provide a sufficient return to attract the necessary capital to sustain their business where government subsidizes a competing mode.

Although rail service has inherent advantages that have been developed partially and await yet greater development, the rail industry, as you know, labors under one big disadvantage; its principal competitor, the trucking industry, is the beneficiary of various types of government subsidies. In 2000, federal highway spending alone came to $27.7 billion, even though the interstate highway system ostensibly is complete. To that, add billions more spent by states. The inland waterways also are maintained at taxpayer expense. Railroads, on the other hand, currently must meet their capital requirements from privately-generated funds, notwithstanding the one recent infrastructure loan program that still awaits implementation. In addition, railroads must continue to pay a "budget reduction" fuel surcharge that is paid into the highway trust fund, thus further benefiting their competition.

The fact is that modal subsidies provide a significant pricing advantage. The simple illustration is that "a parked truck costs nothing" while the cost of rail infrastructure maintenance and depreciation never sleeps. And if 21% of railroad revenues are derived from intermodal traffic which directly competes with trucks, then how does one argue that modal subsidies do not impact pricing? (And, at the same time, how can you argue that there is no competition?) Modal subsidies do affect railroad revenues thereby affecting their competitive ability to attract capital. Just ask Wall Street what would happen to railroad stock prices if trucker user fees were increased.

In addition, what are the resulting externalities of these subsidies? Is not rail a relatively economically and environmentally more efficient mover of goods and services over long distances? What would happen if these subsidies were changed allowing railroads to be more competitive? Would not there be less trucks on the roads around our major metropolitan centers? Would there not be additional private capital to spend on the antiquated infrastructures surrounding our cities, thus providing the means to get goods more effectively from and too these major consuming and delivery points?

The fact is that we cannot have it both ways. We cannot expect to have a viable rail transportation system if public policy hampers its ability to increase its revenue base while, simultaneously, requiring it to be solely responsible for the investment in its infrastructure. Therefore, I view our country and our government as approaching a transportation policy cross-roads: we need to choose between continuing the present policy of private generation of funds for necessary railroad infrastructure improvements with myopic modal subsidization, and inconsistent, semi-regulatory transportation policy, or develop a broad approach that changes the current regulatory and modal-specific environment to a broad, inter-modal policy that may include greater public participation in focused, infrastructure funding. The choice is significant because the consequences are enormous.

For example, increasingly, in order to compete, the railroads continue to consolidate their respective operations so they only operate a route structure that fits into their highest-yield operating model. Railroads are best at operating single-commodity "super-highway" corridors at high capacity with minimum origins and destinations. As soon as multiple origins, multiple commodities and multiple routes are added, there is an exponential increase in the operating complexity and iterations necessary to provide such service. Infinitely worse is the addition of low volume services that increase the costs of operation. Therefore, by necessity, they are becoming selective, taking steps -- big steps -- in the direction of abandoning the old common carrier concept that the franchise holder must take the good with the bad, serve the profitable and unprofitable, and respond to a superior public interest.

The fact is that the railroad industry is simply reacting to the economic reality of the status quo. In order for them to generate privately the funds that they need to enhance their infrastructure and satisfy their investors, they will have to continue taking steps that may be unpleasant for many of their customers and, perhaps, for the political representatives of those customers.

In the area of bulk grain transportation, we are in the midst of a trend toward large, high volume shuttle trains that operate with continuous power between contractually designated destinations and origins where the loaders and unloaders have agreed to expedite origin and destination handling of the train in return for rate concessions. These shuttle trains enable the railroads to offer lower rates where the loaders and unloaders are able to make these high speed loading and unloading commitments, commitments that require substantial equipment and track investments that not all rail customers are willing or able to make.

In this type of a structure, the railroad achieves its goal of handling what it perceives to be its market needs over a minimal route network making the most efficient use of locomotives, cars, and crews. Another benefit realized by the railroad is the concentration on infrastructure funding where traffic densities are likely to be highest. The result is increasing investment into those lines consistently carrying the volume and a reduction in the investment in those peripheral tracks that no longer sustain a sufficient return to justify the investment. The obvious result is consolidation. And this consolidation occurs not only in the track infrastructure but also for the customers.

The company that formerly loaded the grain on the lighter density lines may, and probably will, lose business to the high-speed elevator that participates in the shuttle program. That high speed elevator, in order to attract the large volumes of grain necessary to meet the shuttle train volumes, must offer a better price to farmers to induce them to sell there, rather than someplace else. In return for that better price, the farmers are buying or hiring trucks, bypassing smaller country elevators and short line railroads and going directly to the new, high-speed terminals.

This is but one example of the rational decisions that are made because of current public policy. There are, as I see it, enough segments of society that are impacted by these events in the rail industry to suggest that there is a legitimate reason for across-the-board transportation policy to be considered, rather than just a rail industry focus. There is no question that there are serious infrastructure issues facing all transportation modes. We read almost everyday about infrastructure inadequacies in our airports, air traffic control, river systems, highways, ports, and railroads. In the past, these issues have been addressed separately and competitively without regard to having a national, intermodal transportation policy. The situation today is but one example of the unintended consequences of addressing the issue *en micro.*

To me, the exercise of focusing on one without including all of the others results in the huge risk of “fixing” one while making the whole system worse. In spite of arguments to the contrary, there is modal competition and there is huge intermodal impact in the use and investment in transportation infrastructure. And the inarguable fact is that transportation infrastructure is so costly as to be almost outside the reach of the private sector to fully properly maintain and sustain adequate investment. Therefore, as part of your look at transportation policy, the role of government’s long-term investment should also be considered.